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Leicestershire County Council Pension Fund Q2 2016 - Market Report

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Historic Returns for World Markets

Index	Q2 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	11.48	32.07	6.95
FTSE 100 TR	6.54	3.80	5.32
FTSE 350 TR	4.90	2.34	5.79
FTSE A (Index Linked) British Govt All Stocks TR	9.79	14.85	10.86
FTSE A British Govt All Stocks TR	6.18	13.50	8.12
FTSE A British Govt Over 15 Years TR	11.76	24.09	14.95
FTSE All-Share TR	4.70	2.21	5.85
FTSE Japan TR	8.76	7.75	8.02
FTSE Small Cap TR	-0.62	-1.53	8.20
FTSE World Europe ex UK TR GBP	4.20	6.05	7.66
FTSE World ex UK TR GBP	8.90	15.52	11.96
IPD UK All Property Monthly TR	1.10	8.95	14.33
LIBID GBP 7 Day	0.12	0.49	0.48
Markit iBoxx Sterling Non Gilts Overall TR	4.30	8.97	7.41
MSCI EM (Emerging Markets) TR GBP	8.38	3.86	3.03
MSCI Pacific ex Japan TR GBP	8.27	9.86	5.56
S&P 500 TR	10.16	22.34	16.44
Commodities	12.71	-13.48	-10.63
£ Trade Weighted Index	-5.10	-13.61	0.17

Currency	Q2 (%)	1 Year (%)	3 Years (%)
Euro	4.82	17.30	-1.02
Japanese Yen	17.79	40.32	3.18
US Dollar	7.52	17.65	4.29

Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 30 June 2016. All returns over one year are annualised.

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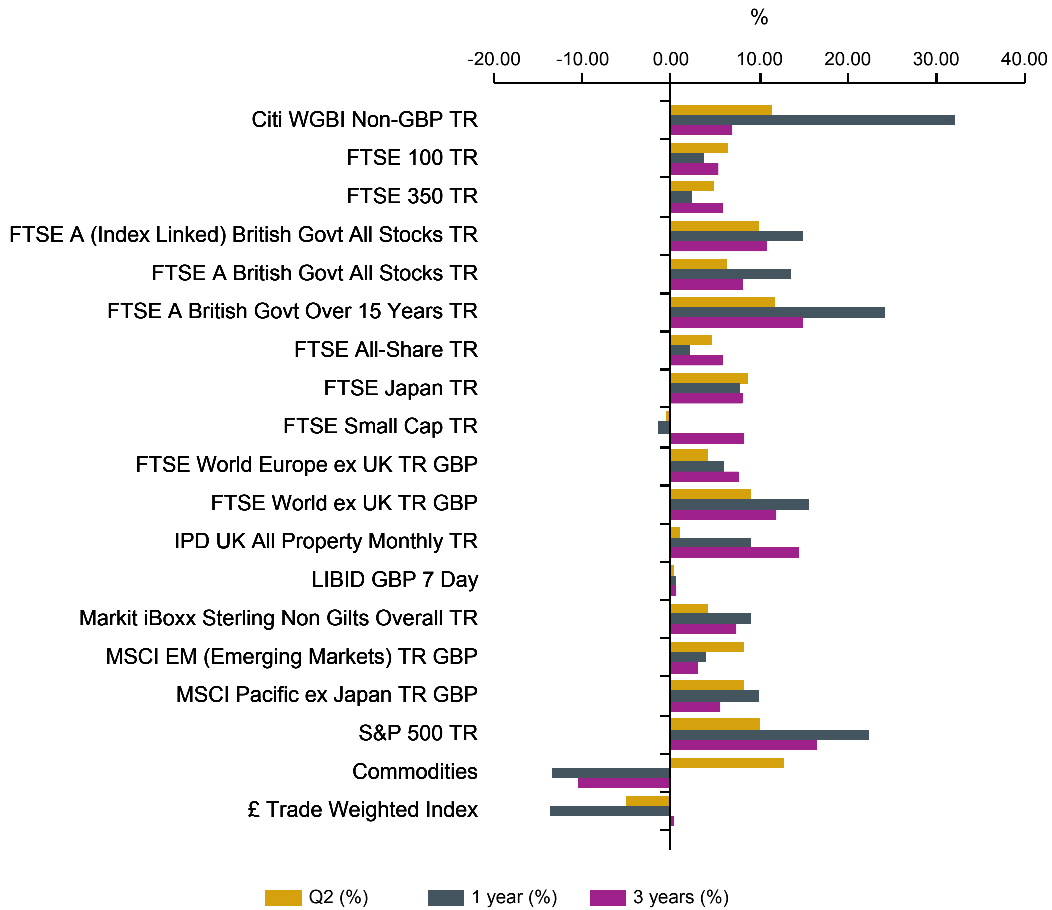
Historic Returns by Market Index

3 months, 1 year and 3 years (annualised)



Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 30 June 2016. All returns over one year are annualised.

Market Review

UK Equities

UK equities advanced over the period, with the FTSE All-Share index returning 4.70%.

GDP growth for the first quarter of 2016, which came in at 0.4%, declined slightly from the figure registered in the final three months of 2015, and inflation slipped slightly by quarter-end as well. The approaching referendum on the UK's membership in the European Union (EU) cast its shadow over most of the quarter, but the Bank of England (BoE) remained supportive, keeping interest rates steady at 0.5%.

In late June, markets were surprised and reacted negatively when the UK voted to leave the EU. Global markets also reacted sharply, and sterling hit lows against the US dollar not seen in more than three decades. The result also ushered in a period of upheaval in British politics, as key figures abandoned their posts in the aftermath of the vote; not least, David Cameron announced his resignation, heralding a Tory leadership campaign. However, the UK market rose in June; the FTSE 100 quickly erased its losses as investors went in search of bargains. However, this resilience should not be a surprise given the index has a heavy weighting to US dollar earning and given the defensive nature of the businesses within the index. Further support came from the BoE, which suggested that it could introduce new stimulus measures. Certain economic figures were also encouraging: unemployment fell to 5.0% in April, its lowest since 2005, and retail sales climbed steadily (year on year) over the period.

As for individual sectors, oil & gas performed markedly better than other areas. Basic materials also finished the quarter strongly, as did the utilities sector, likely due to its defensive nature in a climate of political and economic uncertainty. Laggards included consumer services and financials.

US Equities

In the US, the S&P 500 index rose by 10.16% in sterling terms. Most of this gain was down to the pound's weakness versus the dollar; in US dollar terms the index rose 2.46%.

Economic newsflow in the US was broadly upbeat, with an upward revision to first-quarter GDP growth (1.1%) and significantly increased new-home sales in April. The positive outlook was reflected in the University of Michigan's consumer sentiment survey, which rose to 94.7 in May from 89.0 in April, and slipped only slightly in June.

In terms of monetary policy, the US Federal Reserve maintained interest rates, but amended its language slightly to suggest that a mid-year rate rise was not out of the question. Chair Janet Yellen suggested that an interest-rate rise would "probably" be appropriate "in the coming months". Her case was strengthened by a steep drop in the unemployment figure, which fell to 4.7%, a figure not seen in nearly a decade.

However, markets dropped sharply in the days following the UK's decision to end its membership of the EU, experiencing the worst falls in 10 months and temporarily erasing year-to-date gains. This, coupled with depressed hiring figures, led the Fed to re-examine the macro environment; the bank eschewed rate rises in June and minimally decreased its forecast for 2016 growth, lowering it from 2.1% to 2.0%. It did, however, continue to signal that two rate increases will happen before 2017. Elsewhere, both industrial and manufacturing production fell over the year to May, but business confidence – as measured by the ISM manufacturing purchasing managers' index (PMI) – stayed buoyant, exceeding estimates by rising to 51.3 from April's reading of 50.8.

At a sector level, energy rose strongly. Telecommunication services also proved robust. Information technology was the weakest sector, though still achieved a positive return in sterling terms.

European Equities

The FTSE Europe ex-UK rose by 4.20% in sterling terms, with the pound's weakness boosting returns from overseas equities; the index was down -0.63% in local-currency terms.

While the European Central Bank (ECB) acknowledged early in the quarter that growth was "tilted to the downside", it also put a positive spin on things by revealing the opinion that inflation would improve by year-end. Markets were supported by rising consumer and business sentiment together with a slight increase in first-quarter GDP growth. This improved mood was, in part, driven by the actions of the central bank, which introduced a corporate bond buying programme with a June start date. Progress in negotiations between Greece and its creditors provided an additional lift for sentiment. The International Monetary Fund said it would examine a debt-relief deal offered to Greece by Eurogroup ministers and, depending on its findings, decide before the end of the year whether to join the bailout.

European equity markets were naturally shaken in late June by the UK's decision to leave the EU. But prior to that decision − which analysts expect will curb the eurozone's advancement somewhat – positive data was seen in the form of a return to inflation. Consumer prices in the area rose by an estimated 0.1% over the year to June, the first positive reading since January, boosted by more stable oil prices. Both industrial and manufacturing production registered improvements; the former beat expectations to bounce 2.0% over the year to end April, while the latter expanded as a result of stronger exports. Sovereign debt in some of Europe's peripheral countries also experienced gains as a result of the Brexit turmoil: yields on 10-year Spanish, Italian, and Portuguese bonds fell on the prospect that the ECB could take steps to calm European markets.

Japanese Equities

The FTSE Japan rose by 8.76% in sterling terms, but fell -7.67% in local currency terms.

Participants in the Japanese market continued to worry about the lasting vigour of the yen. Hopes that the Bank of Japan would counteract the climb with additional quantitative easing failed to come to fruition, which only served to boost the currency further. A 0.5% expansion in GDP was recorded in the three months to March, up from a contraction of 0.3% in the last calendar quarter of 2015. The figure was helped by greater spending by both the Japanese government and consumers. In future, the latter group should be encouraged by Prime Minister Shinzo Abe's announcement during the month that his government's planned rise in sales tax has been postponed until late 2019. However, this also gave the impression that the economic benefits of Abenomics might not be taking hold as well as was hoped.

The Japanese equity market was hit hard in the hours following the confirmation of Britain's exit from the EU; the Nikkei closed nearly 8% lower on 24 June, experiencing its worst single-day loss since 2011, before recovering into the month-end. As for broader economic data, unemployment held steady at 3.2% in April, but wage growth slowed. Elsewhere, a continuously strong yen dented Japanese exports, and a more than ¥40 billion deficit was recorded for May as Japanese products became more expensive in overseas markets. Consumerism at home slowed as well, with retail sales falling by 1.9% over the year to May.

The telecommunications sector was strong over the quarter, one of the few to achieve a positive return in yen terms. Financials was a notable laggard, particularly the financial services and life insurance subsectors.

Asia Pacific ex-Japan Equities

Asian markets advanced during the quarter, with the MSCI Pacific ex Japan index returning 8.27% in sterling terms. As with many other indices, most of this gain was due to the weakness of the pound against overseas currencies. In local currency terms the index rose 1.76%.

Chinese policymakers continued to worry about a lack of growth in their region as GDP growth slipped from 6.8% to 6.7% in the first quarter. Though the People's Bank of China refrained from taking steps to stabilise the Chinese currency, they did inject massive sums of cash into the system in an effort to increase liquidity and ease corporate tax strains. The yuan slipped against the US dollar on speculation that the US Fed could move to raise interest rates sooner rather than later. Concerns over stunted growth in China continued into June. The country's manufacturing PMI reading fell to 48.6 in June from 49.2 in May; any figure below 50 indicates a contraction. Inflation slipped back as well, dipping to 2.0% in May after spending three months steady at 2.3%; lower food prices were a determining factor in the fall. While the People's Bank of China held rates and avoided any other quantitative-easing measures during the month, the gloomy data led to speculation that further central bank activity will be deemed necessary in the coming months.

In April, Indian policymakers cut the benchmark interest rate to 6.5% from 6.75%, which had been widely expected. Indeed, India was one of a number of Asian markets which rose in response to favourable economic data in the period. Indian GDP growth reached 7.9% year over year, while industrial production enjoyed a similar rate of expansion, increasing by 7.37% in March from a negative reading in February. Thailand's economy expanded by 0.9% from 0.8% in the prior quarter, when a slight contraction had been predicted. Showing only short-lived concern about the UK's vote to leave the EU, stock markets in India, Indonesia, Thailand, and the Philippines all ended the quarter up. Australia benefited from the surging price of gold as investors turned to the metal as a refuge from Brexit fears.

Property

The IPD monthly benchmark showed a 1.10% total return over the quarter ending 30 June 2016.

The UK commercial property market showed a slowdown in the period prior to the referendum, with notably less investment activity caused by market uncertainty. In some sectors this led to a cooling in pricing as investors held off making decisions and the market lost momentum.

When the UK voted to leave the European Union on 23 June, this marked the beginning of a period of economic and political uncertainty. Financial markets responded to the result quickly and negatively.

Investors who were concerned about the market after Brexit chose to withdraw their investments from property, causing several of the open ended, daily traded, property funds to suspend redemptions. These excessive outflows have now largely abated and the market has calmed. Some of these funds are now seeing positive inflows again as investors see opportunity in the market and view property as an attractive investment with an income return.

As property valuations are backward looking and evidence based, values at the end of June have not reflected the full impact of the Brexit vote. As a result, managers of daily traded, open ended, property funds, which are open to retail investors, have made market value or redemption price adjustments in an attempt to ensure that all investors are treated fairly.

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Fixed Income

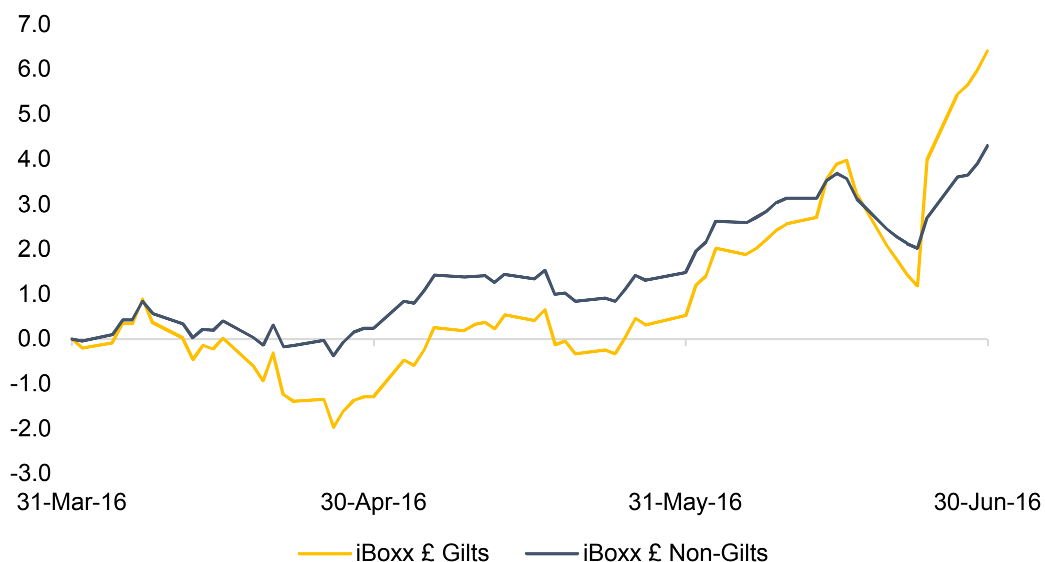
The second quarter of 2016 was, by any measure, an eventful period. Clearly, the most significant development was the UK referendum on European Union membership, which resulted in a vote to leave. Given the seismic shock this had on the political and economic landscape, it would be easy to forget that the vote actually took place as the quarter was coming to an end.

In the first two months of the period, bond markets performed in a similar manner to previous quarters. Supportive Central Bank activity coupled with ongoing concerns about the global economy generally dictated the direction of travel. This left government bond markets in particular trading within a relatively well-defined range. At the same time the corporate bond sector took comfort from a modest but healthy supply line, ongoing strong demand and the European Central Bank's decision to extend its quantitative easing programme to include select corporate bonds.

This rather subdued backdrop changed in June, with signs that investors were moving into 'risk-off' mode, which in turn supported government bonds. Initially, the increased caution was due to a very disappointing US jobs report for May, but the looming UK referendum quickly became the central cause of investor anxiety.

The date of the referendum (Thursday, 23 June 2016) is sure to find a permanent place in history text books. The electorate's decision to bring to an end the UK's 43-year relationship with the EU caused a political earthquake. The impact on financial markets, at least initially, was equally strong, although some assets fared much better than others. Sterling was the main loser as it weakened dramatically against both the US dollar and the euro. In contrast, the clear winners were index-linked assets and core government bonds, in both June and the quarter as a whole. Corporate bond markets – both investment grade and high yield – came under some pressure in June but also enjoyed strong returns for the quarter although both assets were some way off the stellar returns seen in their government bond counterparts.

Strong returns from fixed income



Source: Markit, total return, percentage growth

Government bonds – record low yields

The outcome of the referendum caused government bonds in the US, UK, Germany and Japan to reach record lows. At the same time yields increased in the peripheral regions of Europe as investors' shunned their higher-risk profile.

The strength of the move into the perceived safety of core assets was also due to the expectation that Central Banks would once again have to step in to calm markets. In the UK, this belief was strengthened when Bank of England governor Mark Carney announced a £250 billion facility which commercial lenders could call upon if they were facing liquidity struggles. A potential cut in interest rates during the summer was also suggested.

The resultant move in yields for the quarter as whole left UK gilts up over 6%, with longer-dated bonds (15-year and over) posting a very impressive return of over 11%. The performance of index-linked gilts was also strong, returning almost 10%.

Table 1: 10-year yield movements in core and European periphery benchmark bonds

	Core government bonds				Peripheral Europe				
Country	UK	US	Germany	Japan	Spain	Italy	Greece	Ireland	Portugal
Yield at end March 2016	1.42	1.77	0.15	-0.03	1.43	1.22	8.48	0.73	2.93
Yield at end June 2016	0.87	1.47	-0.13	-0.22	1.16	1.26	8.18	0.52	2.99
Change in yield	-0.55	-0.30	-0.28	-0.19	-0.27	0.04	-0.30	-0.21	0.06

Source: Bloomberg.

Investment grade bonds

Investment grade bonds also performed well over the quarter; in total return terms the iBoxx £ Non-Gilts index returned 4.30%.

In sector terms, financials (particularly banks and insurance companies) performed well in the first two months of the quarter and generally outperformed non-financials. This pattern reversed in June with financials coming under pressure from the referendum result. Banks and insurance companies were among the weakest areas (relative to other corporate bond sectors) and Italian banks bore the brunt of the pain, although large household banking names in the UK were also affected.

Despite the relative weakness in financials, corporate bonds overall rallied in tandem with their government bond cousins, although to a much lesser extent. The main source of support was, again, the realisation that Central Banks would be forced to keep interest rates 'lower for much longer' in order to combat not only an ongoing fragile global economic backdrop but also the effects of the UK's vote to leave the EU. This realisation served as a reminder that investment grade bonds would remain an attractive option for investors seeking yield in a low interest rate environment.

It is also worth noting that while financial bonds struggled in June compared to other bond sectors, by the end of the quarter they had recovered some of their poise. Moreover, there were some indications that, to date, the fall-out from the UK's referendum vote was perhaps not as severe as expected.

High yield bonds

The Barclays Global High Yield index returned 4.43% over the quarter, with US high yield clearly outperforming its European equivalent.

In April and May the high yield market performed strongly as commodity prices (specifically oil) continued to rise and investment flows showed signs of life. The decline in volatility allowed more issuers to come to the primary market with both the US and Europe seeing the greatest volume of issuance. However, new-issue volumes still remained substantially lower than at the same point in 2015.

As an asset class, global high yield bonds performed relatively well following the EU referendum result, with the market seeing a valuation decline of around 1.5% only. This reflects the market's light exposure to UK corporations (around 6%) and its tendency to be dominated by domestic US and multi-national issuers.

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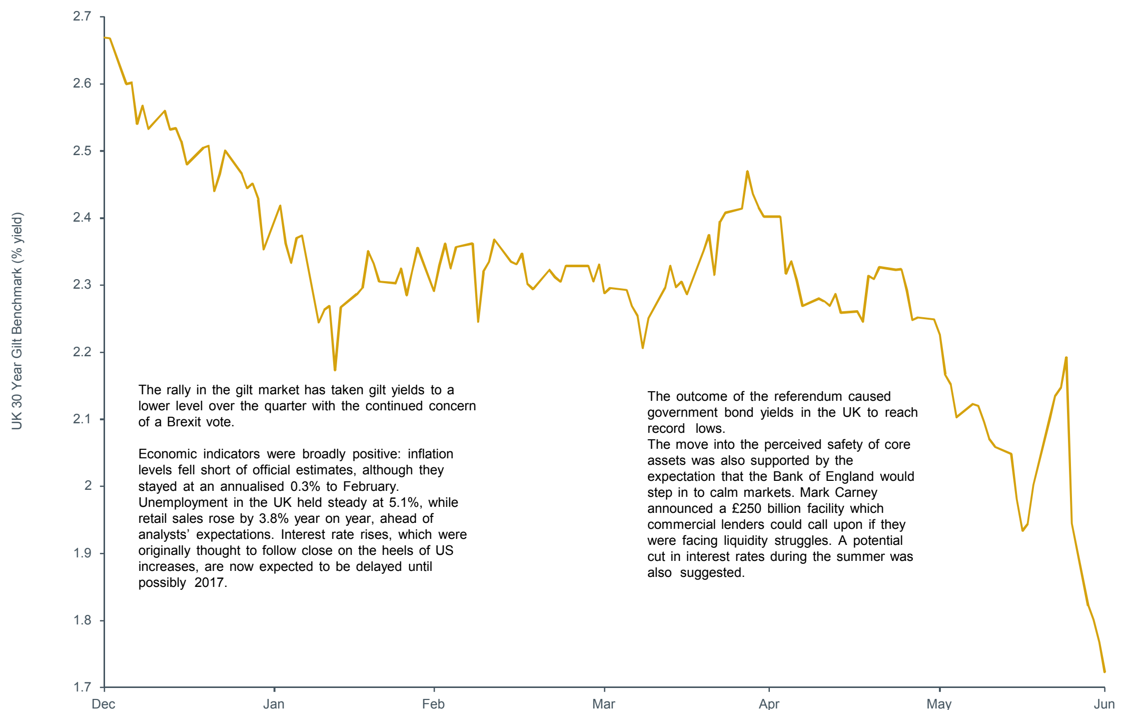
Key Market Movements

The following charts provide a pictorial summary of key market movements during the six-month period to end of June 2016

Global Equities (FTSE World – Price Index)

Source: Datastream

Long Gilts (War Loans 3.5% Perpetual)



Source: Datastream

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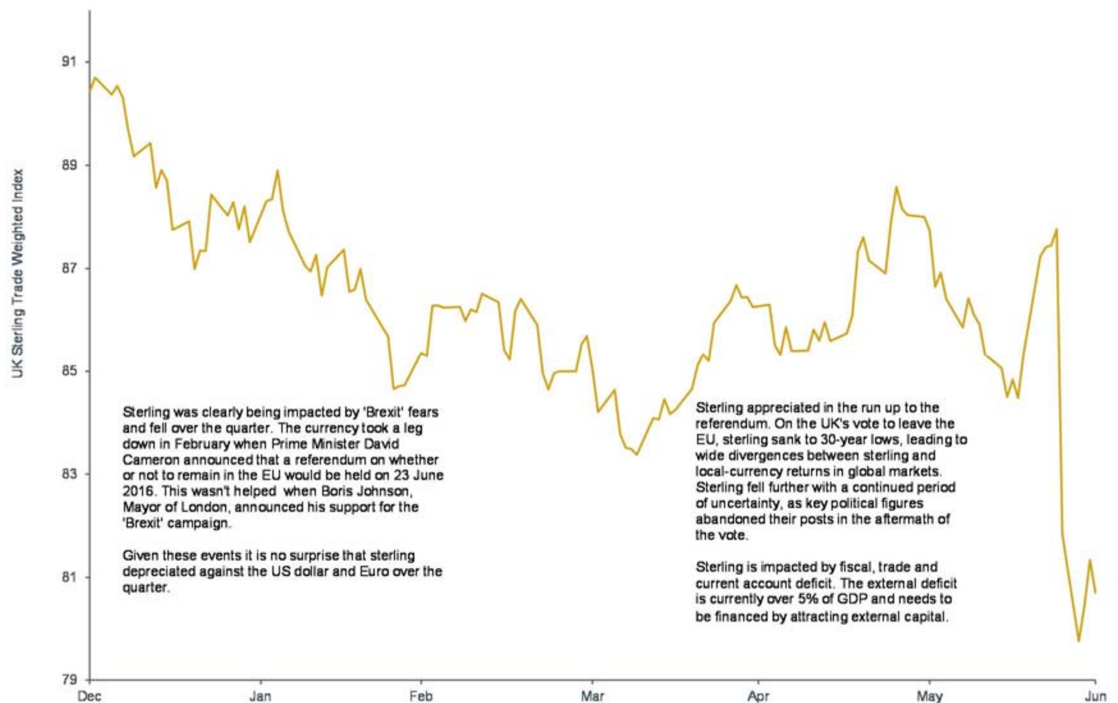
Oil Price (Crude Oil Spot WTI Cushing ($per barrel))

Source: Datastream

UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

Quarterly Thought Piece

On Thursday 23 June 2016, the UK signalled its intention to sue for divorce from its collective EU partners. Although their relationship with the UK had become increasingly strained, EU members never thought it would come to this. It remains to be seen if a settlement can be arrived at amicably.

Ahead of the Referendum various examples were given of countries which found the process of reaching trade agreements with the EU unduly lengthy. The UK is the fifth largest economy in the world and a major destination for EU output; its negotiating position should prove to be significantly stronger than the likes of Norway or Greenland.

The initial financial market reaction to the UK Referendum result proved to be more muted than most commentators suggested. We were consistent with many in the market in adopting a broadly neutral position in our balanced funds ahead of an event, the outcome of which none could call.

The Referendum result has exposed strong divisions within the UK. The decision to leave the EU was more strongly supported, for example, by that portion of the population that owned fewest assets and so was least exposed to the revaluation of asset prices generated by quantitative easing (QE) and the evaporation of interest rates. These are the people who are at the wrong end of the iniquitous redistribution of wealth that has occurred in recent years. They have cried ‘enough’ and, in doing so, have echoed the call of many across the developed world.

Recent months have seen a growing demand for a more holistic approach to economic reflation – one that goes beyond monetary policy to embrace powerful fiscal action. So far, that clamour has been ignored not least because politicians have found themselves tied to a platform of debt reduction. Brexit could provide the excuse for a radical – and global – policy change, one which delivers money to the masses. Echoing the words of Keynes, we would not be surprised if Brexit proved to be the fact that allows politicians to change their minds. If so then this would be a significant input to our investment thinking.

It is clear that changes to monetary policies are now close to being ineffective; when negative interest rates don’t lead to stronger consumption and corporate investment then what else can you do? There is no incentive to borrow (to invest/spend) today when the expected future path of interest rates suggests that ultra-low interest rates are here to stay. Near-zero borrowing costs ‘kick-start’ activity when there is a sense of scarcity - that sense is missing. ‘Low for long’ has been a credit market theme for a while. ‘Low forever’ is a theme that is developing and looks set to define all financial markets for the rest of this decade. In this scenario long-duration bonds remain attractively priced.

A powerful fiscal policy effort that targets a sharp increase in the money available to those with a high propensity to spend will directly fuel a lift in consumer spending and reinforce the influence of ultra-low borrowing costs. Such policies have been tried before, such as in the US and Japan, but these tended to be one-off measures which failed to generate a self-sustaining lift in consumption and economic activity. What could be tried now is a combination of higher wages, lower taxes and infrastructure investment. In combination these policies will have a better chance of working.

The enduring impact is likely to be an increase in the trend rate of price growth (inflation). The challenge is for this to happen in a way that doesn’t erode corporate profitability – a weaker corporate sector employs fewer workers who, in aggregate, spend less. This isn’t an easy balancing act to master but is one which governments need to master (most likely by lowering company taxation). If successful, the foundation for a more supportive environment for real assets generally will have been laid.

Overall then the Referendum result will, as a minimum, inevitably generate a ‘punctuation point’ for the UK economy. Individual and company plans will be put on hold until the dust clears - if enough of us choose to do nothing for a while then a recession will result. This will induce a policy response – the Bank of England has said as much - that will hopefully (if it involves fiscal actions), prove potent. We believe this could support equity markets generally although it will be important to ensure that the stock-by-stock implementation is finessed appropriately. Under this scenario, a higher run-rate for inflation is in prospect and we will look to capture this in ways that aren’t already prohibitively expensive. For those investors able to access it, the outlook for gold has improved markedly.

Sterling looks likely to continue to trade weakly on the foreign exchanges as some safe-haven premium is lost and until politics in the UK become less confused. One of the challenges in the existing arrangement has been that the Eurozone needs a stronger, more cohesive fiscal and political platform if it is to survive. These were pre-conditions that the UK found very difficult to support. Therefore, on one level the outlook for the Eurozone is improved by the UK leaving the EU. If recent events, however, catalyse a fundamental reassessment of the viability of the Eurozone from within, then a weak euro is inevitable (or could generate a material and global systemic threat). If this occurs then a stronger sterling/euro exchange rate is possible.

Stephen Jones
Chief Investment Officer

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